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ESG Investing and Your Company: Is Your Board Ready?

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Socially responsible investing has become an increasingly dominant feature of investment strategies and portfolio managers.

In the first half of 2018, sustainable funds saw average monthly inflows of [\\$924 million](#), double the inflows during the same period last year. [\\$81.7 trillion](#) in total assets under management were recorded as of April 2018. But directors must carefully consider how ESG—environmental, social, and governance—investment functions within their company, as well as how the company’s operations and choices may impact investment by institutions and other prominent stakeholders.

The Big Picture

ESG investing—also known as “impact,” “responsible,” and “sustainable” investing—is a common strategy focused on ethically and morally responding to new global risks and opportunities while also developing long-term value and considering the needs and voices of a broader group of stakeholders. It covers a broad group of issues and challenges, from climate change to labor standards, and from gender and racial diversity to shareholder rights.

Pension funds and institutional funds have been the loudest voices in ESG matters. One of the most vocal, BlackRock CEO Laurence D. Fink, called for CEOs to create a new model of corporate governance in an open letter earlier this year, writing that “companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.” New York City Pension Funds spearheaded an effort for proxy access, and the California Public Employees’ Retirement System pushed companies to increase disclosures about board members (including gender, age, and skill background)—moving the needle for governance standards.

While the majority of share ownership is concentrated within institutional funds with a “passive” investment mandate, these funds exert a massive influence at corporations. As State Street Global Advisors CEO Ronald O’Hanley put it, “Making ESG a priority isn’t about imposing morals or values, it’s about our belief that these issues have a long-term impact on the health of companies in our portfolio and, as such, are potential risks we think companies need to assess as they would any other. We believe asset stewardship can help make companies get out ahead of these issues.”

Some traditional “activist” investors are also reacting to this trend, shifting their messaging to incorporate an ESG focus into their campaigns and thus better aligning with institutional funds’ initiatives.

Taken as a whole, this changing landscape means boards should regularly review activist and institutional/pension fund campaign activity and weigh their demands against the company’s governance practices to identify vulnerabilities.

ESG Ratings Agencies and Disclosure

Over [85 percent](#) of S&P 500 companies currently file sustainability reports containing ESG metrics. Third-party ESG ratings providers such as Institutional Shareholder Services, MSCI, RepRisk, and Sustainalytics each use a different rating scale and methodology. Regardless of the potential for rating inconsistency, investor demand for companies with high ESG ratings is increasing.

Given these ratings agencies rely on non-GAAP ESG disclosures, information and disclosure have increased alongside investor demand. These reports are often known as corporate social responsibility reports and contain expanded disclosures that cover the ESG landscape. One of the challenges surrounding ESG disclosures is the lack of consistent, standardized disclosure methods. However, several organizations have made inroads in this area, including the Sustainability Accounting Standards Board and the Global Reporting Initiative. Boards looking to improve their own ESG reporting should consider reviewing these companies’ research and methods.

The goal behind these disclosure regimes is to enhance investor understanding of material risks while being open to opportunities by expanding reporting transparency beyond the traditional financial statement protocols and offering a potentially more complete picture of an organization.

Questions for Directors to Consider

ESG investing has a wide base of support, as demonstrated by massive investor demand for funds that meet these criteria. Given the current market conditions, ESG investing is likely to remain a key initiative for investors. Companies should be prepared to receive shareholder proposals if their ESG practices do not measure up.

Directors and companies should consider the following questions as they evaluate their organizational ESG practices:

1. What happens to ESG priorities after a market downturn when money managers and pension funds are struggling for alpha?
2. What empirical evidence exists on the idea that alpha is universally improved when ESG matters are considered?
3. Has the board adequately engaged investors on specific ESG priorities?
4. Is the board confident that ESG principles and priorities are part of the company's long-term strategy?

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